

ANALYSIS OF ORIGINAL BILL

Author: Ashburn Analyst: Colin Stevens Bill Number: AB 1914

Related Bills: See Legislative History Telephone: 845-3036 Introduced Date: 2-17-98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Vehicle Bar-97 Smog Inspection Equipment Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow:

- a credit equal to the cost paid by the taxpayer during the year to purchase equipment required for vehicle inspections by the Health and Safety Code to implement Smog Check II; and
- a credit equal to \$50 for each vehicle owned by the taxpayer and tested during the year by equipment required under Smog Check II.

This bill also would make changes to the Health and Safety Code and property tax law regarding Bar-97 equipment. These provisions will not be discussed as they do not impact the Franchise Tax Board (FTB).

EFFECTIVE DATE

This bill would be effective January 1, 1999, and would apply to taxable or income years beginning on or after that date.

LEGISLATIVE HISTORY

AB 208 (Ch. 802, Stats. 1997), AB 1492 (Ch. 803, Stats. 1997).

BACKGROUND

Since 1984, the Bureau of Automotive Repair (BAR) has administered a program which requires that most licensed motor vehicles in the state (except motorcycles, diesel and off-road vehicles) pass a smog test. Under the program as originally enacted, the smog test was required either when the vehicle was sold or every two years when the vehicle was registered, depending upon the area of the state in which the vehicle was registered. Individual garages licensed by the BAR performed the smog checks.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

3/23/98

Agency Secretary

Date

By:

Date:

The 1990 federal Clean Air Act mandated that all states develop a vehicle inspection and maintenance program with certain requirements. In 1994, SB 629 (Ch. 1, Stats. 1994) provided the legal basis for the BAR to administer Smog Check II. The Smog Check II program designates the frequency of smog checks based on an area's smog levels. Areas with the most serious air quality problems are classified as "enhanced areas," and most vehicles are required to be tested every two years. However, vehicles in many rural areas are required to be smogged only upon a change of ownership.

AB 1492 (Ch. 803, Stats. 1997) altered many provisions of Smog Check II and, among other things, exempted from biennial smog check requirements vehicles over 25 years old and new vehicles (for their first four years after purchase).

Smog Check II requires that testing stations in enhanced areas use new equipment meeting a different standard (known as BAR-97), which tests for oxides of nitrogen as well as other emissions. Vehicles in enhanced areas must be tested on a dynamometer, which tests an engine under load and more accurately measures a vehicle's emissions under normal driving conditions. As a result of the BAR-97 standard, testing stations in enhanced areas will no longer be able to use the older equipment known as Bar-90 and instead must purchase new equipment.

SPECIFIC FINDINGS

Federal and state laws allow a variety of tax credits and deductions designed to promote or influence specific taxpayer behavior. Neither federal nor state laws allow a deduction or a tax credit for the cost of purchasing equipment needed to perform smog checks or for smogging a vehicle. However, to the extent smogging a vehicle is considered ordinary and necessary to conduct the taxpayer's business, expenses would be allowed as a business expense deduction.

Federal and state laws allow a depreciation deduction for the cost of purchasing smog check equipment, provided that equipment is used in the conduct of the taxpayer's business. Smog check equipment would be depreciable over a five-year period. In addition, in lieu of depreciation, existing **federal and state laws** allow both noncorporate and corporate taxpayers with a sufficiently small amount of expenditures on depreciable property to elect to deduct as an expense (subject to limitations) the cost of qualified property placed in service for the taxable year.

Under **federal law and state PITL**, the limit is \$19,000 in 1999; \$20,000 in 2000; \$24,000 in 2001; \$24,000 in 2002; and \$25,000 in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible property that is purchased for use in the active conduct of a trade or business. The allowed deduction is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

The B&CTL does not conform to federal expensing treatment. However, the B&CTL allows a taxpayer to deduct 20% of the cost of tangible property in the first year the property is placed in service. The maximum amount of "additional" first year depreciation is \$2,000. In addition, under certain cases such as enterprise zones (EZs) and local agency military base recovery areas (LAMBRAs), corporate as well as personal income taxpayers may elect to treat the cost of qualified property within the zone as an expense in the year placed in service.

Existing state law provides general rules which apply to the division of credits when multiple taxpayers, including partnerships, share in the costs used as the basis of the credit. These rules apply unless an individual credit specifies different rules.

Except as specified, **state law** does not allow any tax credit to reduce regular tax below the tentative minimum tax (TMT) for purposes of the alternative minimum tax (AMT) calculation.

Under the PITL and the B&CTL, this bill would allow a credit equal to the cost paid or incurred by a taxpayer during the taxable or income year to purchase Bar-97 equipment required to perform vehicle smog inspections.

The credit would be in lieu of any deduction to which the taxpayer would otherwise be allowed.

Under the PITL and B&CTL, this bill would allow a credit equal to \$50 for each vehicle owned by the taxpayer and tested during the taxable or income year by Bar-97 equipment under Smog Check II.

For both credits, any unused credit may be carried forward until exhausted.

The general rules regarding the division of credits would apply, and the credit would not reduce regular tax below TMT for alternative minimum tax (AMT) purposes.

Policy Considerations

According to the author's office, the equipment credit was intended to assist taxpayers in defraying the cost of purchasing equipment required under Smog Check II. However, since this bill would become operative January 1, 1999, and most taxpayers purchased Smog Check II equipment in 1997 or 1998, few taxpayers may be able to actually claim the equipment credit. Moreover, providing a tax credit to taxpayers for the 1997 taxable or income year may involve a gift of public funds, and a retroactive operative date could create implementation concerns for the department.

This bill would provide a credit equal to 100% of identified costs for taxpayers purchasing Bar-97 equipment. A 100% credit is unprecedented as a matter of policy, but would reimburse taxpayers for equipment required to operate a smog check business.

This bill would provide a credit for activities taxpayers are required to perform under current state law (smogging a vehicle). On the other hand, providing a credit for smogging a vehicle would defray the cost of performing that activity.

Most credits are enacted with a sunset date so the Legislature may review its effectiveness. This credit has no sunset date.

Although this bill would require that the taxpayer purchase Bar-97 equipment to qualify for credit, it would not explicitly require that the taxpayer use

that equipment in California. Therefore, taxpayers that purchase Bar-97 equipment but use the equipment in other states could qualify for credit in this state.

The \$50 credit for smogging a vehicle is not in lieu of any credit or deduction to which the taxpayer may be eligible. Therefore, if a taxpayer engages in business and has the business's car smogged, the taxpayer could deduct the cost of that smog check and claim a credit for the same smog check.

This bill would allow a credit equal to \$50 to test a vehicle. However, the credit amount is not tied to an expenditure. Therefore, it is possible that a taxpayer could pay less than \$50 to have his or her car smogged and receive a credit greater than the amount actually paid. In addition, there is no requirement that the vehicle ultimately meet acceptable emission standards.

This bill does not provide recapture rules, so a taxpayer could claim a credit for 100% of the cost of BAR-97 equipment and later sell that equipment to another taxpayer, who also could claim the credit.

Implementation Considerations

Department staff is available to work with the author's office to resolve these and other concerns that may arise.

This bill could significantly impact the filing of a California tax return as well as the department's costs due to the factors described below:

1. Currently, individuals with more complex income profiles and related tax calculations report income using Form 540. Special credits may only be reported on Form 540 because they have the potential to be limited by tentative minimum tax (TMT). Calculating the TMT limitation requires a number of steps after referring to an extensive set of instructions. Forms 540A, 540EZ and Telefile are targeted to serve individuals with less complex income profiles, and the TMT calculation is not explained in the related booklets. The objective of targeting is to avoid requiring taxpayers to read instructions or complete schedules they will not need.
2. Since millions of additional taxpayers could claim this credit, it would either require:
 - Millions of taxpayers to switch from simpler forms to the Form 540. The Form 540 costs more to process, has a higher error rate and causes more telephone calls to the department's taxpayer service center than other, simpler forms; or
 - The department to add the TMT calculation to Forms 540A and 540EZ (instructions would be too complex to add to the TeleFile booklet). Such changes could result in significant programming costs. Moreover, if the 540A and 540EZ were modified to accept the credit, significant programming costs would be incurred and additional errors would be expected on these forms.

3. Tax booklet distribution also is targeted to individuals, and they receive the current year booklet based on the tax form they filed last year. The numbers of each type of booklet printed (540, 540A, 540EZ and TeleFile) is relatively stable from one year to another. However, if a significant number of taxpayers shifted between Form 540 and other forms (because they may not be eligible for the credit each year and therefore may not need to file Form 540), the effectiveness of book distribution would decrease and could result in over or under printing of tax booklets.

In recent credits, the Legislature has limited the number of years the unused credit may be carried forward since most credits are exhausted in eight years. This bill permits an unlimited carryover of any unused credit.

Neither credit would require that a taxpayer receive or retain documentation relating to the purchase of Bar-97 equipment. Department staff are not experts in the area of automobile repair and may have difficulty determining whether equipment qualifies under Bar-97 standards. The potential for conflicts between taxpayers and department staff, would be decreased if the taxpayers would be required to provide documentation that the Bar-97 equipment meets BAR standards. Additionally, the \$50 smog check credit would not require that smog check operators provide documentation that a taxpayer's smog check was performed using Bar-97 equipment. The smog check operator should provide documentation to the customers, since many individuals would not know what type of equipment was used to perform a smog check on their vehicle.

FISCAL IMPACT

Departmental Costs

This bill could result in significant costs to the department. However, with the implementation concerns unresolved, those costs cannot accurately be calculated.

Tax Revenue Estimate

It is department staff's understanding that the author's intends for this proposal to be retroactive for expenses paid or incurred for the purchase of Bar-97 equipment for use in California and a credit for vehicles tested by Bar-97 equipment. Therefore, it is assumed the operative date for this bill will be amended to be January 1, 1998. Based on the discussion below, the following table reflects the estimated impact of this proposal:

Estimated Revenue Impact AB 1914					
Assumed Retroactive					
To Taxable or Income Years Beginning 1/1/97					
(In Millions)					
	1998-9	1999-0	2000-01	2001-02	2002-03
Bar-97 Equipment - Credit	(\$35)	(\$30)	(\$20)	(\$20)	(\$10)
Vehicle Credit for Testing	(\$145)	(\$135)	(\$170)	(\$135)	(\$170)
Total	(\$180)	(\$165)	(\$190)	(\$155)	(\$180)

Estimates reflect applied credits in the respective years and does not consider possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion

Vehicle Credit

The revenue impact for this provision of the bill would be determined by the number of vehicles smog tested by Bar-97 testing equipment and the available tax liabilities of taxpayers claiming the credits.

This estimate was developed in several steps. First, according to the California Smog Check Program Unit, the total number of smog checks required for 1996 and 1997 is 17.2 million, with approximately 60% in the first year and 40% in the second. Second, this number was reduced 10% to allow for those individuals who do not comply and non-operating vehicles. This number was further reduced 40% to allow for those vehicles located outside of the major metropolitan areas, which do not require testing by Bar-97 equipment. Third, it was estimated based on departmental data and the department's personal income tax model, that only 65% of the credits generated will be used because not all taxpayers will have sufficient tax liabilities. According to the same data over 80% of these credits will be applied in the first year, and the balance in the second year.

Bar-97 Equipment Credit

The revenue impact for this provision of the bill would be determined by its effective date, the number of Bar-97 equipment purchased, the cost of Bar-97 equipment, and the tax liabilities of taxpayers claiming the credits.

For purposes of the estimates, it was assumed that each Bar-97 equipment would entitle the original and any subsequent owners to no more than the original cost of the equipment in total. For example, if the original owner sells/transfers the equipment to another taxpayer, their combined credits could not exceed 100% of the original cost.

The estimate was developed in the following steps. First, according to the California Inspection and Maintenance Review Committee, the total number of units purchased for Bar-97 equipment is estimated to be 4,500 with

approximately 20% of the units purchased prior to January 1, 1998. Second, according to the same source the cost of Bar-97 equipment plus installation is estimated to be approximately \$60,000. This cost does not include interest payments on loans; it is assumed that interest for equipment loans does not qualify as equipment cost. Third, due to insufficient tax liabilities and the tentative minimum tax interaction, it was assumed that only 50% of credits generated would be used over a period of six years.

Finally, adjustments were made to account for the offsetting tax effect of deductions for depreciation that would be otherwise allowed under current law.

BOARD POSITION

Pending.